

Internal Revenue Service
memorandum

CC:TL-N-4515-90
VWATERS

date: JUN 7 1990

to: District Counsel, Houston CC:HOU
Attn: Jeffrey N. Kelm

from: Acting Branch Chief
Tax Shelter Branch CC:TL:TS

subject: [REDACTED] - Conversion of Partnership Items
TL-N-4515-90
CC:TL:TS Waters, Wilson
I.R.C. § 6229
Statute of Limitations, TEFRA

This memorandum is in response to your request dated March 6, 1990, regarding the above-mentioned subject.

ISSUE

Whether a notice of deficiency can include adjustments to fraudulent partnership items where such items are converted to nonpartnership items more than one year before a notice of deficiency is issued?

CONCLUSION

Where partnership items convert to nonpartnership items, the Service should issue a statutory notice of deficiency within one year from the date on which the items converted to nonpartnership items in accordance with I.R.C. § 6229(f). In this case, where the one year period under section 6229(f) has expired, those converted partnership items should not be included in a notice of deficiency. Because this case presents favorable facts for arguing a "statute extension" interpretation of section 6229, however, we are seeking authority from the Chief Counsel to pursue it as a test case for the proposition that section 6229 extends the otherwise applicable period under section 6501. Under that theory, this case could be pursued on the grounds that the period under section 6501(c)(1) remains open.

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FACTS

In late [REDACTED] the taxpayer, [REDACTED], formed approximately [REDACTED] partnerships to market the [REDACTED] securities tax shelter program. [REDACTED] backdated the partnership formation documents so that it would appear that the partnerships were formed on [REDACTED]. That date was two days prior to a retroactive change in the tax law which effectively eliminated the tax advantages of the [REDACTED] program. In addition, [REDACTED] was aware that [REDACTED] entered into transactions after the effective date of the law change, and backdated the transactions to appear as if the transactions were entered into prior to the effective date of the change in the tax law. Despite this knowledge, the backdated transactions were claimed on the partnership tax returns partnership by [REDACTED]. [REDACTED] has pled guilty to fraud with respect to these transactions.

In the middle of [REDACTED], [REDACTED] filed a petition of bankruptcy. A notice of deficiency was not issued by the District Director within one year of the bankruptcy petition.

DISCUSSION

The tax treatment of partnership items is determined at the partnership level in a unified partnership level audit and proceeding. See I.R.C. § 6221. As a general rule, section 6229(a) provides that the period for assessing any tax imposed by subtitle A attributable to partnership or affected items shall not expire before 3 years after the later of the date the partnership return was filed or the last day for filing such return (determined without regard to extensions).

The partnership items of a partner who files a bankruptcy petition become nonpartnership items pursuant to section 6231(b)(1)(D) and regulations thereunder. Section 6231(b)(1)(D) provides:

(b) Items Cease To Be Partnership Items in Certain Cases.-

(1) In general.-For purposes of this subchapter, the partnership items of a partner for a partnership taxable year shall become nonpartnership items as of the date-

(D) such change occurs...under subsection (c) [special enforcement areas] of this section.

Section 6231(c) provides that the Secretary may promulgate regulations under which items may be treated as nonpartnership items if they present special enforcement considerations. The partnership items of a partner who is named as a debtor in a bankruptcy petition are items which the Secretary has determined to present special enforcement considerations under section 6231(c). The regulations provide that the items become nonpartnership items upon the filing of the bankruptcy petition. See Temp. Treas. Reg. § 301.6231-7T(a). As a consequence, the debtor/partner no longer has an interest in the outcome of the TEFRA proceeding and can no longer participate in such proceeding. I.R.C. § 6226(d).

(f) **Items Becoming Nonpartnership Items.**- If, before the expiration of the period otherwise provided in this section for assessing any tax imposed by subtitle A with respect to the partnership items of a partner for the partnership taxable year, such items become nonpartnership items by reason of 1 or more of the events described in subsection (b) of section 6231, the period for assessing any tax imposed by subtitle A which is attributable to such items (or any item affected by such items) shall not expire before the date which is 1 year after the date on which the items become nonpartnership items. (Emphasis added)

Section 6501(c)(1) provides that, "[i]n the case of a false or fraudulent return with the intent to evade tax, the tax may be assessed or a proceeding in court for collection of such tax may be begun without assessment, at any time."

The underlying issue in this case is whether the applicable period of limitations for partnership items that have converted to nonpartnership items is governed by section 6229 or section 6501. There are at least two interpretations of the general rule found at section 6229(a). One position is that section 6229(a) extends the three year period of limitations for all items, including partnership items, set out by section 6501(a) (hereinafter referred to as the "statute extension" interpretation). The other position, which is the current position of this office, is that section 6229(a) sets out a separate three year period of limitations for partnership items, while section 6501 refers only to nonpartnership items (hereinafter referred to as the "separate period" interpretation).

The uncertainty on this issue stems, in part, from differences in the language of the two "general rules" found at section 6501(a) and section 6229(a). Section 6501(a) states that any tax "shall be assessed" within three years of the filing of

an individual return. Section 6229(a), on the other hand, states that the period of limitations "shall not expire before" three years after the filing of the partnership return.

The primary argument for a separate statute approach is that section 6229(b)(2) implies that section 6229 is separate from section 6501 rather than a mere extension of section 6501. Section 6229(b)(2) states:

Coordination with section 6501(c)(4).—Any agreement under section 6501(c)(4) shall apply with respect to the period described in subsection (a) only if the agreement expressly provides that such agreement applies to tax attributable to partnership items.

If section 6229 merely extended section 6501, an extension of section 6501 should automatically extend the period of limitations for partnership items and a specific reference to partnership items would not be necessary. Thus, the fact that section 6229(b)(2) requires an express reference to partnership items in order for an extension under section 6501(c)(4) to apply to partnership items may indicate that sections 6229 and 6501 provide separate periods of limitations.

On the other hand, it can be argued that the fact that section 6229(b)(2) requires express reference to partnership items in an extension pursuant to section 6501(c)(4) is not inconsistent with the statute extension interpretation. Under a statute extension interpretation, section 6229(a) only comes into play where the otherwise applicable period under section 6501 has expired. In other words, section 6229(a) applies only if it is longer than the initial unextended period under section 6501. Section 6229(b)(2) can be viewed as providing that section 6229(a) will not further extend the section 6501 period once section 6501 has been extended pursuant to section 6501(c)(4) unless express reference is made to partnership items. This interpretation suggests that Congress wanted the Service to have the benefit of the longer of the normal period of limitations under section 6229 or section 6501 in assessing tax attributable to partnership items, while at the same time providing that any extension of section 6501 not apply to partnership items without express reference thereto.

The statute extension interpretation also finds support in the "shall not expire before" language of section 6229(a). The use of that phrase rather than language comparable to section 6501 ("shall be assessed" within 3 years) suggests that Congress intended that section 6229 would provide a minimum 3 year period for assessment from the later of the due date or the filing of the partnership return regardless of the otherwise applicable

period under section 6501. In other words, the period for assessing tax attributable to partnership items "shall not expire before" the applicable period under section 6229 even though the otherwise applicable period under section 6501 has expired.

The "shall not expire before" language of section 6229(f) is also favorable to an argument under the statute extension under these circumstances. The apparent purpose of section 6229(f) is to ensure that the Service has at least one year to assess from the date of conversion of the items to nonpartnership items. Consequently, under the statute extension interpretation, section 6229(f) may be viewed as merely extending the otherwise applicable period of limitations for converted items, i.e., section 6501(c)(1). Of course, in this case section 6501(c)(1) is open-ended in any event due to the presence of fraud. In the absence of fraud or some other exception (other than extension) to the three year period of section 6501(a), however, section 6229(f) would provide the Service a minimum of one year from conversion to assess tax attributable to partnership items.

While we recognize the arguments in favor of the statute extension interpretation, former Acting Chief Counsel Peter Scott was briefed regarding the two possible interpretations of section 6229(a), and he determined that the Service should follow the separate statute approach for the reasons set forth above. The separate statute approach was also viewed as fostering greater protection for the Service against expired periods of limitations. Although this office adopted the separate statute approach, Mr. Scott authorized a test case in which the Service took the position that section 6229(a) merely operates to extend the period for assessment under section 6501(a). The test case was authorized only for a situation where the section 6229 period had expired but the section 6501(a) 3 year period was open without regard to an extension.

In this case, [REDACTED]'s partnership items converted to nonpartnership items upon his filing of the bankruptcy petition. See I.R.C. § 6231(c); Temp. Treas. Reg. § 301.6231-7T(a). Because [REDACTED] participated in the fraud in the preparation of the partnership return, section 6229(c)(1)(A) provided that the period of limitations for tax attributable to his partnership items was open-ended. The conversion of his items to nonpartnership items subjects [REDACTED] to the one year period of section 6229(f). As stated above, if the one year period were still open, we would recommend assessing during that time. Where the one year period has already expired, however, it may be argued under the rationale explained above that the "shall not expire before" language is intended to lengthen, but never shorten, the otherwise applicable period of limitations.

We believe this case presents favorable circumstances to argue the statute extension interpretation. However, because the former Acting Chief Counsel authorized a test case only in a situation where the 3 year section 6501(a) period of limitations was still open, it is necessary to request authorization from Chief Counsel Shashy to argue the statute extension interpretation where the period of limitations under section 6501(a) has expired but the period of limitations remains open under section 6501(c). Therefore, we do not recommend issuing the statutory notice at this time. We will be briefing Mr. Shashy on this issue as soon as possible and will contact your office immediately thereafter to inform you whether the Chief Counsel authorizes defense of this case under the separate statute approach.

Should you have any further questions regarding this matter, please contact Vada Waters at (FTS) 566-3289.


CURTIS G. WILSON